AGENDA — June 13, 2000 Business Taxes Committee Meeting

Proposed New Regulation 1706, Drop Shipments, Establishing Drop Shippers' Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

REVISED June 8, 2000

Action 1 — **Proposed Regulation 1706, *Drop Shipments*:**	Adopt either: 1) Staff's proposed language, which provides a rebuttable presumption that the retail selling price on which the drop shipper must report tax is the amount the drop shipper charges its direct customer, plus a 10 percent (10%) mark-up. Operative Date: January 1, 2001 Implementation : Upon OAL approval. Or 2) Industry's proposal, which provides that the selling price on which the drop shipper must report tax is the amount the drop shipper charges its direct customer, without any mark-up. Operative Date: January 1, 2001 Implementation: Upon OAL approval.
Action 2 — **Proposed audit procedures to minimize the possibility that tax is inadvertently collected twice on the same drop shipment transaction. (Audit Manual Chapter 4, *General Audit Procedures*)**	Adopt either: 1) Staff's recommended audit procedures, which include allowing an offset in the drop shipper's audit for use tax transactions when the auditor has verified that use tax was already self-reported or assessed against the consumer, or where the consumer is currently under audit. Operative Date: None Implementation : Upon Board approval. Or 2) Industry's alternative audit procedures, which include the provision that questioned drop shipment transactions subject to use tax are eliminated from the audit of the drop shipper once it has been determined that the consumer is registered with the Board. Operative Date: None Implementation : Upon Board approval.
Action 3 — Authorization to Publish (whichever language is approved)	Direct the publication of the proposed regulation as adopted in the above action.

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Proposed New Regulation 1706, Drop Shipments, Establishing Drop Shippers' Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

REVISED June 8, 2000

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry
Action 1 – Regulation 1706 *Drop Shipments.*		*(Text of regulation was drafted by staff to embody industry's proposal, since industry did not submit suggested language.)*
	Proposed Regulation 1706, *Drop Shipments.*	**Proposed Regulation 1706, *Drop Shipments.***
	(a) **DEFINITIONS.** For purposes of this regulation:	(a) **DEFINITIONS.** For purposes of this regulation:
	(1) "Retailer engaged in business in this state" means and includes any person who would be so defined by Revenue and Taxation Code section 6203 if the person were a retailer.	(1) "Retailer engaged in business in this state" means and includes any person who would be so defined by Revenue and Taxation Code section 6203 if the person were a retailer.
	(2) "True retailer" means and includes a retailer who is not a retailer engaged in business in this state and who makes a sale of tangible personal property to a consumer in California.	(2) "True retailer" means and includes a retailer who is not a retailer engaged in business in this state and who makes a sale of tangible personal property to a consumer in California.
	(3) "Drop shipment" means and includes a delivery of tangible personal property by an owner or former owner thereof, or factor or agent of that owner or former owner, to a California consumer pursuant to the instructions of a true retailer.	(3) "Drop shipment" means and includes a delivery of tangible personal property by an owner or former owner thereof, or factor or agent of that owner or former owner, to a California consumer pursuant to the instructions of a true retailer.

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Proposed New Regulation 1706, Drop Shipments, Establishing Drop Shippers' Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

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	(4) "Drop shipper" means and includes an owner or former owner thereof, or factor or agent of that owner or former owner, who makes a drop shipment of tangible personal property. (b) **GENERAL.** A drop shipment generally involves two separate sales. The true retailer contracts to sell tangible personal property to a consumer. The true retailer then contracts to purchase that property from a supplier and instructs that supplier to ship the property directly to the consumer. The supplier is a drop shipper. A drop shipper that is a retailer engaged in business in this state is reclassified as the retailer and is liable for tax as provided in this regulation. When more than two separate sales are involved, the person liable for the applicable tax as the drop shipper is the first person who is a retailer engaged in business in this state in the series of transactions beginning with the purchase by the true retailer. (c) **APPLICATION OF TAX** (1) Unless the sale to the California consumer and the use by the California	(4) "Drop shipper" means and includes an owner or former owner thereof, or factor or agent of that owner or former owner, who makes a drop shipment of tangible personal property. (b) **GENERAL.** A drop shipment generally involves two separate sales. The true retailer contracts to sell tangible personal property to a consumer. The true retailer then contracts to purchase that property from a supplier and instructs that supplier to ship the property directly to the consumer. The supplier is a drop shipper. A drop shipper that is a retailer engaged in business in this state is reclassified as the retailer and is liable for tax as provided in this regulation. When more than two separate sales are involved, the person liable for the applicable tax as the drop shipper is the first person who is a retailer engaged in business in this state in the series of transactions beginning with the purchase by the true retailer. (c) **APPLICATION OF TAX** (1) Unless the sale to the California consumer and the use by the California

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry
	consumer are exempt from sales and use tax as otherwise provided in the Sales and Use Tax Law, a drop shipper must report and pay tax measured by the retail selling price of the property paid by the California consumer to the true retailer. (2) Except as provided in subdivision (d)(3) of this regulation, for reporting periods commencing on or after January 1, 2001, a drop shipper may calculate the retail selling price of its drop shipments of property based on its selling price of the property to the true retailer plus a mark-up of 10 percent (10%). A drop shipper may use a mark-up percentage lower than 10 percent if the drop shipper can document that the lower mark-up percentage accurately reflects the retail selling price charged by the true retailer to the California consumer. If a mark-up percentage lower than 10 percent is developed in an audit of the drop shipper, the drop shipper may use that percentage for the subsequent reporting periods provided the drop shipper has not had a significant change in business operations. Provided there is no significant change in business operations, if a later audit develops a higher percentage, the	consumer are exempt from sales and use tax as otherwise provided in the Sales and Use Tax Law, commencing on or after January 1, 2001, a drop shipper may report and pay tax measured by the selling price of the property paid by the true retailer.

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	Board would not assess additional tax based on that newly computed mark-up percentage. However, for subsequent reporting periods, the lower mark-up from the previous audit cannot be used, and the drop shipper must instead use the higher percentage developed in the most recent audit or 10 percent, whichever is lower. (3) The procedures set forth in subdivision (d)(2) of this regulation do not apply to drop shipments of vehicles, vessels, and aircraft (also known as "courtesy deliveries"). For purposes of this regulation, "vehicle," "vessel," and "aircraft" are defined in Sections 6272, 6273, and 6274 of the Revenue and Taxation Code, respectively. (d) **EXAMPLES.** (1) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in this state. XYZ Inc. is the drop	(d) **EXAMPLES.** (1) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in this state. XYZ Inc. is the drop

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	shipper liable for the applicable tax as the retailer. (2) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in California. XYZ Inc. then contracts with Supplies Corp. to purchase the tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Whether or not Supplies Corp. is a retailer engaged in business in this state, XYZ Inc. is the drop shipper liable for the applicable tax as the retailer. (3) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is not a retailer engaged	shipper liable for the applicable tax as the retailer. (2) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in California. XYZ Inc. then contracts with Supplies Corp. to purchase the tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Whether or not Supplies Corp. is a retailer engaged in business in this state, XYZ Inc. is the drop shipper liable for the applicable tax as the retailer. (3) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is not a retailer engaged

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	in business in this state. XYZ Inc. then contracts with Supplies Corp. to purchase the tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Supplies Corp. is a retailer engaged in business in this state. Supplies Corp. is the drop shipper liable for the applicable tax as the retailer. (4) Dropshipper Company is a drop shipper of tangible personal property to California consumers on behalf of retailers who are not retailers engaged in business in this state. During its last audit, the Board developed and applied a mark-up of 8½ percent. During the current audit, the Board develops a mark-up of 11 percent. The Board will apply a mark-up of 8½ percent in the current audit provided there was no significant change in Dropshipper Company's business operations between the prior audit period and the current audit period. If there was a significant change in business operations, the Board will apply a mark-up percentage of 10 percent in the current audit. For periods after the current audit period, Dropshipper Company must use a 10 percent mark-up percentage. (5) In the previous example, Dropshipper	in business in this state. XYZ Inc. then contracts with Supplies Corp. to purchase the tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Supplies Corp. is a retailer engaged in business in this state. Supplies Corp. is the drop shipper liable for the applicable tax as the retailer.

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	Company sold only computer hardware during the period covered by the prior audit, but in the period covered by the current audit, it also made considerable sales of computer software. Since there was a significant change in Dropshipper Company's business operations after the prior audit period, the mark-up of 8½ percent developed during that audit does not apply. The Board will apply a mark-up of 10 percent (because it is lower than the 11 percent mark-up developed during the audit).	
	(e) **BURDEN OF PROOF**	(e) **BURDEN OF PROOF**
	(1) An owner or former owner of tangible personal property, or a factor or agent of that owner or former owner, who, upon the instructions of that person's customer, delivers property to a California consumer is presumed to be a drop shipper liable for the applicable tax as the retailer. A person may overcome this presumption by accepting a timely resale certificate from that person's customer that includes a valid California seller's permit number. The acceptance of a resale certificate that does not include a valid California seller's permit number will not overcome the presumption.	(1) An owner or former owner of tangible personal property, or a factor or agent of that owner or former owner, who, upon the instructions of that person's customer, delivers property to a California consumer is presumed to be a drop shipper liable for the applicable tax as the retailer. A person may overcome this presumption by accepting a timely resale certificate from that person's customer that includes a valid California seller's permit number. The acceptance of a resale certificate that does not include a valid California seller's permit number will not overcome the presumption.

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	(2) A person otherwise qualifying as a drop shipper under this regulation can overcome the presumption that the delivery is to a consumer by accepting a timely and valid resale certificate in good faith from the person in California to whom the property is delivered.	(2) A person otherwise qualifying as a drop shipper under this regulation can overcome the presumption that the delivery is to a consumer by accepting a timely and valid resale certificate in good faith from the person in California to whom the property is delivered.

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Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry
Action 2 – Audit Procedures	**PROPOSED DROP SHIPMENT AUDIT PROCEDURES (**Audit Manual Chapter 4, *General Audit Procedures*): Sales and Use Tax Transactions - If the drop shipment transaction is subject to either sales or use tax, the auditor should verify whether the true retailer holds a California seller's permit or Certificate of Registration – Use Tax. If the true retailer holds a California seller's permit or Certificate of Registration – Use Tax, the auditor should allow the transaction in the drop shipper's audit as a sale for resale. If the true retailer is not registered with the Board but the auditor determines that the true retailer is, in fact, engaged in business in this state, then the auditor should allow the transaction in the drop shipper's audit as a sale for resale and notify the appropriate district office of the facts showing that the true retailer is engaged in business in California. The auditor should also verify whether the consumer in California to whom the property was drop shipped holds a valid seller's permit, consumer use tax permit, Certificate of Registration – Use Tax, or use tax direct payment permit. If the consumer is registered	**PROPOSED DROP SHIPMENT AUDIT PROCEDURES (**Audit Manual Chapter 4, *General Audit Procedures*): Sales and Use Tax Transactions - If the drop shipment transaction is subject to either sales or use tax, the auditor should verify whether the true retailer holds a California seller's permit or Certificate of Registration – Use Tax. If the true retailer holds a California seller's permit or Certificate of Registration – Use Tax, the auditor should allow the transaction in the drop shipper's audit as a sale for resale. If the true retailer is not registered with the Board but the auditor determines that the true retailer is, in fact, engaged in business in this state, then the auditor should allow the transaction in the drop shipper's audit as a sale for resale and notify the appropriate district office of the facts showing that the true retailer is engaged in business in California.

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	with the Board, staff proposes that the auditor verify whether the tax was already reported by the consumer or included in an audit of the consumer. "Included in the audit of the consumer" includes situations where the consumer's purchases were examined on an actual basis, or on a sample basis and the drop shipper's transaction was included in the population sampled. If an assessment was made based on the actual basis examination of the consumer's purchases, the liability due on the drop shipper's transaction would be eliminated. If an assessment was made based on errors found in a sample being projected over the audit period, the liability due on the drop shipper's transaction would be eliminated – even if the specific drop shipment purchase was not selected as a sample item. If no errors were noted, or if the errors were not projected over the audit period, the drop shipper's transaction would remain in the audit of the drop shipper.	
	Use Tax Transactions –	Use Tax Transactions - The auditor should also verify whether the consumer in California to whom the property was drop shipped holds a valid seller's permit, consumer use tax permit, Certificate of Registration – Use Tax, or use tax direct

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	If the consumer is registered with the Board and an audit of the consumer is in progress, the transaction should be included as a liability of the consumer if the transaction is within the audit period of the consumer. If the Board is barred by statute from assessing tax against the consumer, the liability should remain in the audit of the drop shipper. When auditing a retailer in California it is standard procedure to examine the taxpayer's paid bills for any unreported purchases subject to use tax. During the examination of paid bills, if the auditor becomes aware that the consumer's purchase was the result of a drop shipment transaction, the auditor should verify if tax was already reported by the drop shipper before assessing the tax against the consumer. If the auditor determines that the transaction was already reported or assessed against the drop shipper, the transaction should not be included in the audit of the consumer.	payment permit. If the consumer is registered with the Board, and the transaction is subject to use tax, the sale should be eliminated from the audit of the drop shipper.

Issue Paper Number 00 - 018

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

☐ Board Meeting
☒ Business Taxes Committee
☐ Customer Services and Administrative Efficiency Committee
☐ Legislative Committee
☐ Property Tax Committee
☐ Other

Proposed New Regulation 1706, *Drop Shipments*, Establishing Drop Shippers' Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

I. Issue

How can the Board relieve the compliance difficulties facing retailers engaged in business in California who drop ship goods to California consumers pursuant to retail sales made by retailers not engaged in business in California?

II. Staff Recommendation

Adopt staff's proposed Regulation 1706, *Drop Shipments*, which provides a rebuttable presumption that the retail selling price on which the drop shipper must report tax is the amount the drop shipper charges its direct customer plus a 10 percent mark-up. A drop shipper may use a mark-up percentage lower than 10 percent if the drop shipper can document that the lower mark-up percentage accurately reflects the retail selling price charged by the true retailer to the California consumer. Since staff's proposed Regulation 1706 includes a new alternative reporting method, staff recommends an operative date of April 1, 2001, to facilitate the implementation of the proposed regulation.

Staff further recommends adding audit procedures to the Sales and Use Tax Department Audit Manual Chapter 4, *General Audit Procedures*, for drop shipment transactions to minimize the possibility that tax is inadvertently collected from both the drop shipper and the California consumer on the same transaction. The recommended procedures include the provision that the questioned sale transaction be eliminated from the audit of the drop shipper when the auditor has verified that the tax was already self-reported or assessed against the consumer. In a use tax transaction if the consumer is currently under audit, the transaction will be included in the audit liability of the consumer.

III. Other Alternative(s) Considered

Adopt industry's proposal to have Regulation 1706 provide that the selling price on which the drop shipper must report tax is the amount the drop shipper charges its direct customer. Since industry's proposal would provide a new interpretation of section 6007, an operative date of April 1, 2001, is recommended to facilitate the implementation of the proposed regulation.

In addition, adopt industry's proposal to add audit procedures to the Sales and Use Tax Department Audit Manual Chapter 4, *General Audit Procedures*, for drop shipment transactions including the provision that questioned sale transactions are eliminated from the audit of the drop shipper once it has been determined that the consumer is registered with the Board.

IV. Background

The administrative difficulties faced by drop shippers in determining the retail selling price of drop shipped merchandise was discussed at the December 7, 1999 Business Taxes Committee meeting. During the discussion, the Board suggested that a rebuttable presumption could be adopted that the selling price on which tax is due is equal to the drop shipper's selling price plus some percentage. The Board directed industry and staff explore an alternative method for determining the retail selling price of drop shipped merchandise. The Board also directed staff to work with industry to develop administrative procedures that will minimize the possibility that tax is inadvertently collected from both the drop shipper and the California consumer.

In his letter of January 13, 2000, Mr. Fred A. Brenner, Jr., the Vice-President, Taxes/Assistant Treasurer for Steelcase, Inc. explained the difficulty in determining the retail selling price of drop shipments and the administrative burden placed on drop shippers. To relieve this burden, Mr. Brenner proposed the Board allow a drop shipper to report its tax liability based on the amount they charge their customer (the true retailer). Mr. Kenneth E. Evans, the President of Lancaster Colony Commercial Products, Inc., supported Steelcase, Inc.'s proposal in his February 18, 2000 letter. (Steelcase Inc. and Lancaster Colony Commercial Products, Inc. will hereinafter be referred to as "Industry.")

Industry representatives and staff discussed Industry's concerns at interested parties meetings on February 25, 2000, and April 11, 2000. Industry reiterated its position that the best regulatory action would be to establish the drop shipper's retail selling price at the amount the shipper charges its direct customer. Industry stated its belief that section 6007 can be interpreted to mean that "the retail selling price of the property" is the drop shipper's selling price to their customer. Staff restated its position that the current language of the statute does not allow for this interpretation.

Staff and Industry also discussed the Board's suggestion of establishing a specific mark-up percentage that drop shippers could use to calculate the retail selling price on drop shipments, including how a drop shipper could rebut the presumption if its customers' mark-up was lower. Staff and Industry also discussed the possibility of establishing separate mark-up percentages for different industries, requiring drop shippers to provide listings of their customers, and excluding courtesy deliveries of vehicles, vessels and aircraft from the provisions of a drop shipment regulation.

Discussion – Current Application of Tax to Drop Shipments

Under existing law, sales tax is imposed on retailers for the privilege of selling tangible personal property at retail in California. When the sales tax does not apply, the use tax is imposed on the storage, use, or other consumption of tangible personal property purchased from a retailer. The sales tax is imposed on the retailer, and the use tax is imposed on the purchaser. However, under Revenue and Taxation Code section 6203, a retailer who is "engaged in business in this state" must collect the California use tax from the California consumer and remit that tax to the Board.

The sales tax was first adopted in California in 1933, and it applied only to sales in California. This meant that sales of tangible personal property shipped into California from outside the state were not subject to tax. After adoption of the sales tax, it was clear that this put California retailers at a disadvantage in comparison with their out-of-state competitors. In 1935, the Legislature adopted the use tax to alleviate this disadvantage. Shortly thereafter, in 1939, the Legislature further refined the use tax provisions of the law by adopting the drop shipment rule, which is in Revenue and Taxation Code section 6007. This rule provided further protections for California retailers from tax advantages gained by out-of-state retailers who were not engaged in business in this state.

In general, drop shipment transactions involve two separate sales involving three persons: the consumer, the retailer (hereinafter referred to as the "true retailer"), and the supplier or manufacturer (hereinafter referred to as the "drop shipper"). The true retailer contracts to sell property to the consumer. The true retailer then contracts to purchase that property from the drop shipper and instructs the drop shipper to ship the property directly to the consumer. Section 6007 deems the drop shipper to be the retailer liable for reporting sales or use tax under specified circumstances.

When a drop shipment is made to a California consumer and both the true retailer and the drop shipper are engaged in business in California, then the usual rules apply: the drop shipper is making a sale for resale and the true retailer is liable for payment of tax to the Board measured by the retail price paid by the consumer. If neither the true retailer nor the drop shipper is engaged in business in California, then California cannot impose a use tax collection duty on either party, and only the consumer is liable to the Board for payment of use tax measured by the retail price paid. However, if the drop shipper is engaged in business in California but the true retailer is not, the drop shipment rule of section 6007 applies. Under such circumstances, section 6007 specifically deems the drop shipper to be the retailer of the property for purposes of the Sales and Use Tax Law, and imposes liability on the drop shipper for payment to the Board of tax measured by the retail price paid by the consumer.

Discussion – Establishing the Retail Selling Price at the Drop Shipper's Selling Price.

Industry proposes that a drop shipper coming within section 6007 be liable for tax based on the amount it charges its customer (the true retailer). This is the only amount always known by the drop shipper. Administratively, it is much easier for a drop shipper to collect tax on an amount it knows and which it can verify in its own records than on the amount paid by the consumer to the true retailer. Industry believes that the current language of section 6007 can be interpreted to allow for this treatment if the sentence of section 6007 is interpreted to mean that "the retail selling price of the property" is the drop shipper's selling price to their customer, the true retailer.

Staff, however, believes section 6007 requires that the tax reported by the drop shipper be based on the retail selling price paid by the consumer. This interpretation of the statute has been consistently applied since 1939 when the Legislature adopted the drop shipment rule. In addition, in *Lyon Metal Products, Inc. v. State Board of Equalization* (1997) 58 Cal.App.4th 906, the Court of Appeal not only upheld the validity of California's drop shipment rule in section 6007, but also specifically recognized that a drop shipper covered by section 6007 is liable for tax measured by the retail price paid by the consumer. (58 Cal.App.4th 912.)

The drop shipment rule of section 6007 was not intended to provide an exemption for part of the measure of tax; rather, it is simply intended to impose the sales tax or use tax collection liability on the drop shipper. Under industry's proposal, however, the measure of tax would be reduced from the retail price to the wholesale price, creating a partial exemption not authorized by section 6007. Thus, while staff agrees that a regulation adopting an alternative which establishes a specified mark-up percentage over the drop shipper's charge to the true retailer is administratively feasible and worthwhile, the law does not permit the alternative value to be set at the cost to the true retailer. Such a method would require legislative action.

Discussion - Establishing the Retail Selling Price at the Drop Shipper's Selling Price Plus a Specific Mark –up Percentage.

To ease the administrative burden of drop shippers, it has been suggested that the Board adopt a regulation that would establish a specific mark-up percentage that drop shippers could use to calculate the retail selling price on drop shipments (Exhibit 3). The percentage would be a "safe harbor" that drop shippers could use for reporting purposes, or rebut if they had documentation to support that the true retailers' mark-up percentage was lower. As an established safe harbor, the Board would not assess an amount greater than the percentage specified in the regulation on the drop shipper.

Two proposed alternative methods to rebut the established percentage were discussed at the interested parties meetings. The first proposed alternative is to allow drop shippers to compute the retail selling price using a percentage they develop on their own. The drop shipper would have to support the validity of the lower percentage and periodically verify that the computed percentage remains accurate. This method is similar to how drop shippers currently disprove an auditor-determined mark-up percentage used in an audit.

The second proposed alternative is to allow drop shippers to use a percentage accepted by the Board in a prior audit. If a subsequent audit revealed a higher percentage (which would not exceed the established safe harbor percentage), the drop shipper would be required to use the higher percentage for subsequent reporting periods. The Board, however, would not assess additional tax in the current audit based on the newly computed mark-up percentage.

Staff agrees that using a prior audit percentage is an acceptable proposal for estimating the retail selling price of drop shipments – provided there has not been a significant change in the drop shipper's business operations that would affect the mark-up percentage. For example, if a drop shipper of computer hardware begins drop shipping software, the drop shipper would not be able to use a mark-up percentage developed in a prior audit. Since software is a new product line, the mark-up on software was not considered in the prior audit and thus not reflected in the prior audit percentage. The drop shipper would have to develop and support its own mark-up percentage for its business after the addition of software sales or use the safe harbor percentage established in staff's proposed regulation.

In his April 25, 2000 letter (Exhibit 4), Mr. Michael Lewakowski, Manager, State and Local Taxes for Steelcase, Inc. expressed his concern that the term "significant change" is somewhat nebulous and should be more clearly defined to avoid future compliance problems.

Discussion – Requiring a Listing of California Consumers

As part of allowing drop shippers to use an alternate method to calculate the taxable retail selling price of drop shipped merchandise, staff proposed that drop shippers be required to provide the Board with information regarding the California consumers to whom they drop ship merchandise in use tax transactions. The listing would have included the name and address of each such California consumer along with a description of the property and the selling price the drop shipper reported to the Board.

After discussing this issue at the April 11, 2000 interested parties meeting, both staff and Industry agreed that requiring drop shippers to provide this type of listing would be too burdensome and prevent many drop shippers from taking advantage of the regulatory safe harbor provisions. It was decided not to include the list requirement in the proposed regulation.

Discussion - Establishing Separate Mark-up Percentages for Different Industries that Drop Ship Merchandise in California

At the February 25, 2000 interested parties meeting, it was suggested that separate mark-up percentages be established for different industries. Staff agreed to research the feasibility of this suggestion by surveying the Board's district offices for information regarding the different types of merchandise drop shipped in California. (Before conducting the survey, staff confirmed that because almost any business can drop ship merchandise, the Board does not track or code taxpayers that drop ship merchandise.) The districts examined 95 audits involving drop shipments. The results of the survey show that a wide variety of products are drop shipped to California consumers – forklifts to footwear, computers to window coverings, printed material to manufacturing equipment (Exhibit 5). The survey also shows that a wide variety of mark-ups were used in the audits of drop shippers. Since the mark-ups found in the survey are from single audits, staff concluded that it would not be reasonable to assume that the mark-ups reflect industry averages.

The wide variety of products, compounded with the problem of defining who is included in a particular industry, leads staff to conclude that developing separate mark-up percentages for different industries is not desirable. In fact, establishing separate mark-up percentages could complicate rather than ease the administrative reporting burden of drop shippers whose products fall into more than one industry category. For example, an office product retailer may drop ship both office supplies and office furniture. If separate percentages were established for office supplies and office furniture, the drop shipper would have to perform separate calculations for each type of product.

In its April 25, 2000 letter, Steelcase, Inc. agreed that establishing separate mark-up percentages is not desirable.

Discussion – Courtesy Deliveries of Vehicles, Vessels and Aircraft

Drop shipments of vehicles, vessels and aircraft are generally referred to as "courtesy deliveries." In general, there are two types of courtesy delivery transactions. Using vehicles as examples, in the first type of courtesy delivery, an out-of-state dealer contracts to sell a vehicle to a customer in California and directs the manufacturer to deliver the vehicle to a specific California dealer, who will redeliver it to the customer. The delivering dealer normally charges the manufacturer for new car preparation, but the vehicle is not entered in the dealer's inventory. The second type of courtesy delivery also involves an out-of-state dealer contracting to sell a vehicle to a customer in California; however in this case a delivery agreement is reached directly between an out-of-state dealer and a California dealer. The vehicle is taken from the California dealer's inventory, and the local dealer invoices the out-of-state dealer for the car.

In either type of transaction, if the out-of-state dealer does not have a California seller's permit and dealer's license from the California Department of Motor Vehicles, the California dealer must report sales tax based on the retail sales price paid by the customer to the out-of-state dealer.

Staff believes that courtesy deliveries of vehicles, vessels and aircraft should be specifically excluded from the provisions of a drop shipment regulation. Unlike typical drop shipment transactions, the customer in California works closely with both the out-of-state seller and the California dealer. Consequently, the California dealer does not have the same difficulty in determining the final selling price to the consumer, as does the typical drop shipper. In addition, the California dealer has the ability to withhold delivery until he or she is advised of the retail selling price of the vehicle, vessel or aircraft and is reimbursed for the sales tax liability (unlike most drop shipment transactions).

Industry has not submitted correspondence disagreeing with the exclusion of vehicles, vessels and aircraft from the drop shipment provisions of staff's proposed Regulation 1706.

Discussion – Increase in E-Commerce Sales

According to the January 2000 California Legislative Analyst's Office's report, "California Tax Policy and the Internet," national Internet business-to-consumer transactions, which were estimated at less than $10 billion in 1998, are estimated to have grown to $20 billion in 1999. Retail e-commerce is expected to reach between $100 billion and $200 billion by 2003. The portion of these dollars related to California transactions is unknown; however, it is estimated that California retail e-commerce currently is several billion dollars annually.

At this time there is no specific data regarding the number of e-commerce transactions that involve drop shipments. However, because Internet technology facilitates the ability of businesses to conduct commerce on a "remote" or out-of-state basis, it is reasonable to assume that as e-commerce increases, the number of drop shipments into and within California will also increase. Staff recognizes that as the number of drop shippers increases, ease of compliance with Section 6007 will become increasingly critical.

Discussion – Establishing Procedures for Audits of Drop Shipment Transactions

At the December 7, 1999 Business Taxes Committee meeting, the Board directed staff to work with industry to develop administrative procedures to minimize the possibility that tax is inadvertently collected from both the drop shipper and the California end user. The Board of Equalization's Audit Manual does not include specific procedures for auditing drop shipment transactions. To promote consistency in auditing and minimize the possibility that tax is inadvertently collected twice, staff recommends adding procedures to Chapter 4, *General Audit Procedures*, of the Board's Sales and Use Tax Department Audit Manual for drop shipment transactions.

> Sales and Use Tax Transactions - If the drop shipment transaction is subject to either sales or use tax, the auditor should verify whether the true retailer holds a California seller's permit or Certificate of Registration – Use Tax. If the true retailer holds a California seller's permit or Certificate of Registration – Use Tax, the auditor should allow the transaction in the drop shipper's audit as a sale for resale. If the true retailer is not registered with the Board but the auditor determines that the true retailer is, in fact, engaged in business in this state, then the auditor should allow the transaction in the drop shipper's audit as a sale for resale and notify the appropriate district office of the facts showing that the true retailer is engaged in business in California.

> The auditor should also verify whether the consumer in California to whom the property was drop shipped holds a valid seller's permit, consumer use tax permit, Certificate of Registration – Use Tax, or use tax direct payment permit. If the consumer is registered with the Board, staff proposes that the auditor verify whether the tax was already reported by the consumer or included in an audit of the consumer. "Included in the audit of the consumer" includes situations where the consumer's purchases were examined on an actual basis, or on a sample basis and the drop shipper's transaction was included in the population sampled. If an assessment was made based on the actual basis examination of the consumer's purchases, the liability due on the drop shipper's transaction would be eliminated. If an assessment was made based on errors found in a sample being projected over the audit period, the liability due on the drop shipper's transaction would be considered eliminated – even if the specific drop shipment purchase was not selected as a sample item. If no errors were noted, or if the errors were not projected over the audit period, the drop shipper's transaction would remain in the audit of the drop shipper.
>
> Use Tax Transactions – If the consumer is registered with the Board and an audit of the consumer is in progress, the transaction should be included as a liability of the consumer, if the transaction is within the audit period of the consumer. If the Board is barred by statute from assessing tax against the consumer, the liability should remain in the audit of the drop shipper.
>
> When auditing a retailer in California, it is standard procedure to examine the taxpayer's paid bills for any unreported purchases subject to use tax. During the examination of paid bills, if the auditor becomes aware that the consumer's purchase was the result of a drop shipment transaction, the auditor should verify if tax was already reported by the drop shipper before assessing the tax against the consumer. If the auditor determines that the transaction was already reported or assessed against the drop shipper, the transaction should not be included in the audit of the consumer.

In the April 11, 2000 interested party meeting and in its April 25, 2000 letter, Steelcase, Inc. expressed its disagreement with staff's proposed audit procedures for use tax transactions. Industry believes that once it has been determined that the consumer is registered with the state of California, the sale should be eliminated from the audit of the drop shipper. Thus, it would not be necessary for the auditor to determine whether use tax has been self-assessed or included in an audit of the consumer in order to relieve the drop shipper of their responsibility to collect the tax. If the auditor does determine that the use tax was not reported by or assessed against the consumer, the Board's collection ability is facilitated because the consumer is permitized. Using this procedure, the state is collecting tax from the party who is truly liable for the use tax – the California consumer.

Staff disagrees with Industry's proposed procedure because it undermines the intent of Revenue and Taxation Code section 6203, *Collection by the Retailer*, which imposes the duty to collect use tax on retailers who are engaged in business in California. Staff is concerned that this procedure would have to be expanded to all use tax transactions to ensure consistency in the Board's audit procedures. In effect, this proposal could be interpreted to mean that any retailer who ships goods in use tax transactions would not have to collect use tax when they sell to customers who are permitized with the Board. Staff believes that while the scope of Industry's proposed procedure is currently limited to drop shipments, its implementation would open the door to new procedures that would contradict the purpose of section 6203. Furthermore, ex-tax purchases from out-of-state vendors are consistently the largest single area of taxpayer noncompliance found in sales and use tax audits. With only about three percent of the accounts being audited in any given year, the Audit Program could not be relied upon to ensure that all use tax is properly reported or assessed. Staff also believes that industry's proposed audit procedure would not necessarily allow the Board to assess the use tax against the consumer. If a drop shipper signed a waiver of limitation extending the time period of their audit, staff may be barred by the statute of limitations from assessing the liability against the consumer.

V. Staff Recommendation

A. Description of the Staff Recommendation

Adopt staff's proposed Regulation 1706, *Drop Shipments*, which provides a rebuttable presumption that the retail selling price on which the drop shipper must report tax is the amount the drop shipper charges its direct customer plus a 10 percent mark-up. A drop shipper may use a mark-up percentage lower than 10 percent if the drop shipper can document that the lower mark-up percentage accurately reflects the retail selling price charged by the true retailer to the California consumer. Since staff's proposed Regulation 1706 includes a new alternative reporting method, staff recommends an operative date of April 1, 2001, to facilitate the implementation of the proposed regulation.

Staff further recommends adding audit procedures to the Sales and Use Tax Department Audit Manual Chapter 4, *General Audit Procedures*, for drop shipment transactions to minimize the possibility that tax is inadvertently collected from both the drop shipper and the California consumer on the same transaction. The recommended procedures include the provision that the questioned sale transaction be eliminated from the audit of the drop shipper when the auditor has verified that the tax was already self-reported or assessed against the consumer. In a use tax transaction if the consumer is currently under audit, the transaction will be included in the audit liability of the consumer.

B. Pros of the Staff Recommendation

- Provides an option for those drop shippers who have difficulty in determining the selling price to the consumer.
- Provides a "safe harbor" percentage where the drop shipper will not be held responsible for additional tax if the actual mark-up percentage is higher than 10 percent.
- Proposed audit procedures would require auditors to verify if use tax has already been reported or paid by a permitized consumer. This would promote consistency in audits and minimize the possibility that use tax is collected from both the purchaser and the seller on the same transaction.

C. Cons of the Staff Recommendation

Proposed audit procedures for use tax transactions are contrary to the procedures proposed by Industry.

D. Statutory or Regulatory Change

No statutory change required. However, it does require the adoption of a regulation.

E. Administrative Impact

None.

F. Fiscal Impact

1. Cost Impact

Costs related to the new regulation are absorbable.

2. Revenue Impact

The revenue impact is dependent on the difference between the actual mark-up on drop shipments and the 10 percent mark-up included in the proposed Regulation 1706. The actual difference is unknown. However, as an indication of the revenue impact, if the actual mark-up were 15 percent, the 5 percent difference would result in an estimated $200,000 annual decrease in sales and use taxes collected. See Revenue Estimate, Exhibit 1.

G. Taxpayer/Customer Impact

Proposed Regulation 1706 will affect retailers engaged in business in California that drop ship merchandise to California consumers pursuant to retail sales made by retailers not engaged in business in California. Staff will notify taxpayers of the regulation's provisions through an article in the Tax Information Bulletin. Staff will also incorporate the audit procedures in Chapter 4, *General Audit Procedures*, of the Sales and Use Tax Department's Audit Manual.

H. Critical Time Frames

Since proposed Regulation 1706 includes a new alternative reporting method, staff recommends an operative date of April 1, 2001 to facilitate implementation of the regulation. There is no operative date for the proposed drop shipment transaction audit manual procedures.

VI. Alternative 1

A. Description of the Alternative

Adopt industry's proposal to have Regulation 1706 provide that the selling price on which the drop shipper must report tax is the amount the drop shipper charges its direct customer. Since industry's proposal would provide a new interpretation of section 6007, an operative date of April 1, 2001, is recommended to facilitate the implementation of the proposed regulation.

In addition, adopt industry's proposal to add audit procedures to the Sales and Use Tax Department Audit Manual Chapter 4, *General Audit Procedures*, for drop shipment transactions including the provision that questioned sale transactions are eliminated from the audit of the drop shipper once it has been determined that the consumer is registered with the Board.

B. Pros of the Alternative

- Provides relief for those drop shippers who have difficulty in determining the selling price to the consumer.
- Provides relief for drop shippers under audit who have not collected use tax from consumers who hold California permits.

C. Cons of the Alternative

- Staff believes that statutory change would be required since it would reduce the measure of tax from the retail price to the wholesale price, thus creating a partial exemption not authorized by section 6007.
- Staff believes the proposed audit procedure undermines the intent of section 6203.
- The proposed audit procedure would not necessarily allow the Board to assess the use tax against the consumer. If a drop shipper signed a waiver of limitation extending the time period of their audit, staff may be barred by the statute of limitations from assessing the liability against the consumer.

D. Statutory or Regulatory Change

Staff believes that statutory change would be required. Alternative 1 also requires the adoption of a regulation.

E. Administrative Impact

None.

F. Fiscal Impact

1. Cost Impact

Costs related to the new regulation would be absorbable.

2. Revenue Impact

The revenue impact is estimated to be a decrease in sales and use tax revenue of $720,000 annually. See Revenue Estimate, Exhibit 1.

G. Taxpayer/Customer Impact

The proposed regulation will affect retailers engaged in business in California that drop ship merchandise to California consumers pursuant to retail sales made by retailers not engaged in business in California. Staff will notify taxpayers of the regulation's provisions through an article in the Tax Information Bulletin.

H. Critical Time Frames

Since the proposed regulation would provide a new interpretation of section 6007, an operative date of April 1, 2001 is recommended to facilitate the implementation of the regulation. There is no operative date for the proposed drop shipment transaction audit manual procedures.

Prepared by: Program Planning Division, Sales and Use Tax Department

Current as of: June 2, 2000

BOARD OF EQUALIZATION
REVENUE ESTIMATE

Proposed New Regulation 1706, *Drop Shipments*, Establishing Drop Shippers' Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

Staff Recommendation

Adopt staff's proposed Regulation 1706, Drop Shipments, which provides a rebuttable presumption that the retail selling price on which the drop shipper must report tax is the amount the drop shipper charges its direct customer plus a 10 percent mark-up. A drop shipper may use a mark-up percentage lower than 10 percent if the drop shipper can document that the lower mark-up percentage accurately reflects the retail selling price charged by the true retailer to the California consumer. Since staff's proposed Regulation 1706 includes a new alternative reporting method, staff recommends an operative date of April 1, 2001, to facilitate the implementation of the proposed regulation.

Staff further recommends adding audit procedures to the Sales and Use Tax Department Audit Manual Chapter 4, General Audit Procedures, for drop shipment transactions to minimize the possibility that tax is inadvertently collected from both the drop shipper and the California consumer on the same transaction. The recommended procedures include the provision that the questioned sale transaction be eliminated from the audit of the drop shipper when the auditor has verified that the tax was already self-reported or assessed against the consumer. In a use tax transaction if the consumer is currently under audit, the transaction will be included in the audit liability of the consumer.

Alternative 1:

Adopt industry's proposal to have Regulation 1706 provide that the selling price on which the drop shipper must report tax is the amount the drop shipper charges its direct customer. Since industry's proposal would provide a new interpretation of section 6007, an operative date of April 1, 2001, is recommended to facilitate the implementation of the proposed regulation.

In addition, adopt industry's proposal to add audit procedures to the Sales and Use Tax Department Audit Manual Chapter 4, *General Audit Procedures,* for drop shipment transactions including the provision that questioned sale transactions are eliminated from the audit of the drop shipper once it has been determined that the consumer is registered with the Board.

Background, Methodology, and Assumptions

Staff Recommendation:

The staff recommendation would provide a rebuttable presumption that the actual retail selling price on which the drop shipper must report tax is equal to the drop shipper's selling price plus a 10 percent mark-up. This provision would allow the drop shipper to rebut the presumption if the actual retail selling price is less than his selling price plus the 10 percent mark-up. However, if the actual retail selling price exceeds this amount, the drop shipper is not liable for the difference.

Staff, in discussions with industry, believes that 10 percent represents a reasonable average mark-up on drop shipment transactions.

In a drop ship transaction, if the goods are shipped to the California end user from a location inside California, the transaction is a sales tax transaction. If the goods are shipped from a location outside California to the end-user in California, the transaction is subject to use tax. In a sales tax transaction, the liability for the tax is on the retailer, in this case the drop shipper. In the situation where the actual retail selling price is greater than the drop shipper's price plus a 10 percent mark-up, the drop shipper is the only person who has a liability for the sales tax, and, if the tax is not paid on the total actual selling price, a loss of revenue would occur.

In a similar use tax transaction, the portion of the total retail sales price not paid by the drop shipper would remain a liability of the consumer. However, since this would most likely be a small amount on each transaction, it would not be cost effective to attempt to bill the consumer for this amount.

In order to determine an average retail selling price, the Sales and Use Tax Department (SUTD) did a survey of recent audits involving drop shipments. That study showed audit liabilities on transactions involving drop shipments amounting to $7.9 million on sales of approximately $98.5 million. This amount includes both sales and use tax transactions. These liabilities covered a normal three-year audit period. The annual transactions represented by these audits are estimated to be $32.8 million. We understand that the application of tax for drop shippers is a difficult issue, and, therefore, this audit amount probably represents a significant number of total transactions involving drop shipments. If we assume that this amount represents one-third of all drop shipment amounts covered by this proposal, then total transactions involving drop shipments amount to an estimated $100 million.

If 10 percent represents the average mark-up on a drop ship transaction, then, on half of these transactions or $50 million, the actual retail selling price will be greater than the drop shipper's selling price plus 10 percent. As an indication of the amount of revenue involved, let us assume that the actual mark-up on these transactions is 15% rather than 10%, The drop shipper's selling price is $43.5 million and the actual mark-up is 15 percent or $6.5 million ($43.5 million + $6.5 million = $50 million). This proposal would set the drop shipper's liability at his selling price, $43.5 million, plus 10 percent, $4.4 million, for a total of $47.9 million. The amount of tax due based on this proposal would be $3.8 million ($47.9 million x 7.92%). The amount of tax due on the actual retail selling price ($50 million x 7.92%) would be $4.0 million. The revenue paid by the drop shipper would be $200,000 less than the amount of the liability on the actual retail selling price.

Alternative 1:

Alternative 1 would provide that the retail selling price on which the drop shipper must report tax is the amount the drop shipper charges their direct customer. Under this alternative, drop shippers would not be held liable for any tax over the amount the drop shippers charge their direct customers.

Annual drop shipments are estimated to be $100 million. Assuming that the actual retail price is the drop shipper's selling price plus 10 percent, the total amount drop shippers charge their direct customers would amount to $90.9 million ($100 million / 1.10 = $90.9 million.) The difference is $9.1 million, which is the amount of actual retail selling price for which the drop shipper would not be liable. In sales tax transactions, the consumer would not be liable for this difference, creating a revenue loss. In use tax transactions, while the consumer would be liable for the difference, this would most likely be a small amount on each transaction, and it would not be cost effective to attempt to bill the consumer for this amount, creating a potential revenue loss. The amount of the revenue loss for both these types of transactions would be $720,000. ($9.1 million x .0792 = $720,000.)

Revenue Summary

Staff Recommendation:

The revenue impact of the staff recommendation is dependent on the difference between the actual mark-up on drop shipments and the 10 percent figure established by this proposal for those transactions in which the actual mark-up is greater than 10 percent. We have no way of knowing what that difference might be. As an indication of the amounts involved, if the average difference was 5 percent, the estimated decrease in sales and use taxes collected from the drop shipper would amount to $200,000 annually.

The Board, on July 28, 1998 determined that eliminating the requirement that out-of-state retailers engaged in business in California collect use tax on drop shipments to California end users results in removing the liability for the tax from the drop shipper but does not change the liability of the end-user for the tax and, therefore, would have no revenue effect.

Alternative 1:

The potential revenue impact of Alternative 1 is estimated to be a decrease in sales and use taxes collected by the drop shipper of $720,000 annually.

The Board, on July 28, 1998, determined that eliminating the requirement that out-of-state retailers engaged in business in California collect use tax on drop shipments to California end users results in removing the liability for the tax from the drop shipper but does not change the liability of the end-user for the tax and, therefore, would have no revenue effect.

Qualifying Remarks

Drop ship transactions in question involve three parties – an in-state consumer, a retailer not engaged in business in California, and a supplier or drop shipper engaged in business in California. These types of transactions are the result of the consumer contacting the retailer by mail or by telephone, or more recently, over the Internet. Currently, estimates of Internet sales of tangible personal property amount to about one-fifth the amount of mail order sales. Some Internet sales are replacing sales that were previously made by mail order. However, it is estimated that this amounts to only about 20 percent of Internet sales. The majority of Internet sales are sales that would have previously been made by in-state retailers. This being the case, the continued increase of Internet sales should be reflected in an increase in drop ship transactions.

Preparation

This revenue estimate was prepared by David E. Hayes, Statistics Section, Agency Planning and Research Division. This revenue estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division and Mr. Geoffrey Lyle, Program Planning Manager, Sales and Use Tax Department. For additional information, please contact Mr. Hayes at (916) 445-0840.

Current as of May 17, 2000

Proposed New Regulation 1706, *Drop Shipments*, Establishing Drop Shippers Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

Comparison of Staff and Industry Proposals

Revised as of June 8, 2000

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
Action 1 — Proposed Regulation 1706	**Proposed Regulation 1706, *Drop Shipments.*** <u>(a) **DEFINITIONS.** For purposes of this regulation:</u> <u>(1) "Retailer engaged in business in this state" means and includes any person who would be so defined by Revenue and Taxation Code section 6203 if the person were a retailer.</u> <u>(2) "True retailer" means and includes a retailer who is not a retailer engaged in business in this state and who makes a sale of tangible personal property to a consumer in California.</u> <u>(3) "Drop shipment" means and includes a delivery of tangible personal property by an owner or former owner thereof, or factor or agent of that owner or former owner, to a California consumer pursuant to the instructions of a true retailer.</u> <u>(4) "Drop shipper" means and includes an owner or former owner thereof, or factor or agent of that owner or former owner, who makes a drop shipment of tangible personal property.</u>	**Proposed Regulation 1706, *Drop Shipments.*** <u>(a) **DEFINITIONS.** For purposes of this regulation:</u> <u>(1) "Retailer engaged in business in this state" means and includes any person who would be so defined by Revenue and Taxation Code section 6203 if the person were a retailer.</u> <u>(2) "True retailer" means and includes a retailer who is not a retailer engaged in business in this state and who makes a sale of tangible personal property to a consumer in California.</u> <u>(3) "Drop shipment" means and includes a delivery of tangible personal property by an owner or former owner thereof, or factor or agent of that owner or former owner, to a California consumer pursuant to the instructions of a true retailer.</u> <u>(4) "Drop shipper" means and includes an owner or former owner thereof, or factor or agent of that owner or former owner, who makes a drop shipment of tangible personal property.</u>	Text of regulation for Alternative 1 was drafted by staff to embody industry's proposal, since industry did not submit suggested language. Staff and Industry agree on general definitions and the explanation of drop shipment transactions.

Proposed New Regulation 1706, *Drop Shipments*, Establishing Drop Shippers Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

Comparison of Staff and Industry Proposals

Revised as of June 8, 2000

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
	(b) **GENERAL.** A drop shipment generally involves two separate sales. The true retailer contracts to sell tangible personal property to a consumer. The true retailer then contracts to purchase that property from a supplier and instructs that supplier to ship the property directly to the consumer. The supplier is a drop shipper. A drop shipper that is a retailer engaged in business in this state is reclassified as the retailer and is liable for tax as provided in this regulation. When more than two separate sales are involved, the person liable for the applicable tax as the drop shipper is the first person who is a retailer engaged in business in this state in the series of transactions beginning with the purchase by the true retailer.	(b) **GENERAL.** A drop shipment generally involves two separate sales. The true retailer contracts to sell tangible personal property to a consumer. The true retailer then contracts to purchase that property from a supplier and instructs that supplier to ship the property directly to the consumer. The supplier is a drop shipper. A drop shipper that is a retailer engaged in business in this state is reclassified as the retailer and is liable for tax as provided in this regulation. When more than two separate sales are involved, the person liable for the applicable tax as the drop shipper is the first person who is a retailer engaged in business in this state in the series of transactions beginning with the purchase by the true retailer.	
	(c) **APPLICATION OF TAX** (1) Unless the sale to the California consumer and the use by the California consumer are exempt from sales and use tax as otherwise provided in the Sales and Use Tax Law, a drop shipper must report and pay tax measured by the retail selling price of the property paid by the California consumer to the true retailer. (2) Except as provided in subdivision (d)(3) of this regulation, for reporting periods	(c) **APPLICATION OF TAX** (1) Unless the sale to the California consumer and the use by the California consumer are exempt from sales and use tax as otherwise provided in the Sales and Use Tax Law, commencing on or after January 1, 2000, a drop shipper may report and pay tax measured by the selling price of the property paid by the true retailer.	Although they did not provide regulatory language, Industry recommends adopting a regulation providing that the retail selling price on which the drop shipper must report tax is the amount the drop shipper charges their direct customer. Staff believes there is no statutory authority to allow this treatment, which reduces the measure of tax from the retail price to the wholesale price, thus creating a partial

Proposed New Regulation 1706, *Drop Shipments*, Establishing Drop Shippers Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

Comparison of Staff and Industry Proposals

Revised as of June 8, 2000

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
	commencing on or after January 1, 2000, a drop shipper may calculate the retail selling price of its drop shipments of property based on its selling price of the property to the true retailer plus a mark-up of 10 percent (10%). A drop shipper may use a mark-up percentage lower than 10 percent if the drop shipper can document that the lower mark-up percentage accurately reflects the retail selling price charged by the true retailer to the California consumer. If a mark-up percentage lower than 10 percent is developed in an audit of the drop shipper, the drop shipper may use that percentage for the subsequent reporting periods provided the drop shipper has not had a significant change in business operations. Provided there is no significant change in business operations, if a later audit develops a higher percentage, the Board would not assess additional tax based on that newly computed mark-up percentage. However, for subsequent reporting periods, the lower mark-up from the previous audit cannot be used, and the drop shipper must instead use the higher percentage developed in the most recent audit or 10 percent, whichever is lower. (3) The procedures set forth in subdivision (d)(2) of this regulation do not apply to drop		exemption not authorized by section 6007. Staff recommends adopting a regulation providing an alternative "safe harbor" calculation of the drop shipper's retail selling price. Both staff and Industry agree that an operative date should be included to facilitate the implementation of the regulation.

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
	shipments of vehicles, vessels, and aircraft (also known as "courtesy deliveries"). For purposes of this regulation, "vehicle," "vessel," and "aircraft" are defined in Sections 6272, 6273, and 6274 of the Revenue and Taxation Code, respectively.		
	(d) **EXAMPLES.**	(d) **EXAMPLES.**	
	(1) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in this state. XYZ Inc. is the drop shipper liable for the applicable tax as the retailer.	(1) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in this state. XYZ Inc. is the drop shipper liable for the applicable tax as the retailer.	Staff and Industry agree on examples of drop shipment transactions.
	(2) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in California. XYZ Inc. then contracts with Supplies Corp. to purchase the	(2) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in California. XYZ Inc. then contracts with Supplies Corp. to purchase the	

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
	tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Whether or not Supplies Corp. is a retailer engaged in business in this state, XYZ Inc. is the drop shipper liable for the applicable tax as the retailer.	tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Whether or not Supplies Corp. is a retailer engaged in business in this state, XYZ Inc. is the drop shipper liable for the applicable tax as the retailer.	
	(3) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is not a retailer engaged in business in this state. XYZ Inc. then contracts with Supplies Corp. to purchase the tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Supplies Corp. is a retailer engaged in business in this state. Supplies Corp. is the drop shipper liable for the applicable tax as the retailer.	(3) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is not a retailer engaged in business in this state. XYZ Inc. then contracts with Supplies Corp. to purchase the tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Supplies Corp. is a retailer engaged in business in this state. Supplies Corp. is the drop shipper liable for the applicable tax as the retailer.	
	(4) Dropshipper Company is a drop shipper of tangible personal property to California consumers on behalf of retailers who are not retailers engaged in business in this state. During its last audit, the Board developed and applied a mark-up of 8½ percent. During the		Examples (4) and (5) are unnecessary under Industry's proposal, since the drop shipper would report tax based on the drop shipper's selling price to their direct customer.

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
	current audit, the Board develops a mark-up of 11 percent. The Board will apply a mark-up of 8½ percent in the current audit provided there was no significant change in Dropshipper Company's business operations between the prior audit period and the current audit period. If there was a significant change in business operations, the Board will apply a mark-up percentage of 10 percent in the current audit. For periods after the current audit period, Dropshipper Company must use a 10 percent mark-up percentage. (5) In the previous example, Dropshipper Company sold only computer hardware during the period covered by the prior audit, but in the period covered by the current audit, it also made considerable sales of computer software. Since there was a significant change in Dropshipper Company's business operations after the prior audit period, the mark-up of 8½ percent developed during that audit does not apply. The Board will apply a mark-up of 10 percent (because it is lower than the 11 percent mark-up developed during the audit).		
	(e) BURDEN OF PROOF (1) An owner or former owner of tangible personal property, or a factor or agent of that	**(e) BURDEN OF PROOF** (1) An owner or former owner of tangible personal property, or a factor or agent of that	Industry and staff agree with respect to the appropriate acceptance of resale certificates.

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
	owner or former owner, who, upon the instructions of that person's customer, delivers property to a California consumer is presumed to be a drop shipper liable for the applicable tax as the retailer. A person may overcome this presumption by accepting a timely resale certificate from that person's customer that includes a valid California seller's permit number. The acceptance of a resale certificate that does not include a valid California seller's permit number will not overcome the presumption. (2) A person otherwise qualifying as a drop shipper under this regulation can overcome the presumption that the delivery is to a consumer by accepting a timely and valid resale certificate in good faith from the person in California to whom the property is delivered.	owner or former owner, who, upon the instructions of that person's customer, delivers property to a California consumer is presumed to be a drop shipper liable for the applicable tax as the retailer. A person may overcome this presumption by accepting a timely resale certificate from that person's customer that includes a valid California seller's permit number. The acceptance of a resale certificate that does not include a valid California seller's permit number will not overcome the presumption. (2) A person otherwise qualifying as a drop shipper under this regulation can overcome the presumption that the delivery is to a consumer by accepting a timely and valid resale certificate in good faith from the person in California to whom the property is delivered.	

Proposed New Regulation 1706, *Drop Shipments*, Establishing Drop Shippers Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

Comparison of Staff and Industry Proposals

Revised as of June 8, 2000

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
Action 2 - Audit Procedures	**PROPOSED DROP SHIPMENT AUDIT PROCEDURES (**Audit Manual Chapter 4, *General Audit Procedures*): Sales and Use Tax Transactions - If the drop shipment transaction is subject to either sales or use tax, the auditor should verify whether the true retailer holds a California seller's permit or Certificate of Registration – Use Tax. If the true retailer holds a California seller's permit or Certificate of Registration – Use Tax, the auditor should allow the transaction in the drop shipper's audit as a sale for resale. If the true retailer is not registered with the Board but the auditor determines that the true retailer is, in fact, engaged in business in this state, then the auditor should allow the transaction in the drop shipper's audit as a sale for resale and notify the appropriate district office of the facts showing that the true retailer is engaged in business in California. The auditor should also verify whether the consumer in California to whom the property was drop shipped holds a valid seller's permit, consumer use tax permit, Certificate of Registration – Use Tax, or use tax direct payment permit. If the consumer is registered with the Board, staff proposes that the auditor	**PROPOSED DROP SHIPMENT AUDIT PROCEDURES (**Audit Manual Chapter 4, *General Audit Procedures*): Sales and Use Tax Transactions - If the drop shipment transaction is subject to either sales or use tax, the auditor should verify whether the true retailer holds a California seller's permit or Certificate of Registration – Use Tax. If the true retailer holds a California seller's permit or Certificate of Registration – Use Tax, the auditor should allow the transaction in the drop shipper's audit as a sale for resale. If the true retailer is not registered with the Board but the auditor determines that the true retailer is, in fact, engaged in business in this state, then the auditor should allow the transaction in the drop shipper's audit as a sale for resale and notify the appropriate district office of the facts showing that the true retailer is engaged in business in California.	Staff and Industry agree that a drop shipment transaction should be allowed as a sale for resale if the true retailer is registered for California sales or use tax, or is not registered but it has been determined that the true retailer is engaged in business in California.

Proposed New Regulation 1706, *Drop Shipments*, Establishing Drop Shippers Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

Comparison of Staff and Industry Proposals

Revised as of June 8, 2000

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
	verify whether the tax was already reported by the consumer or included in an audit of the consumer. "Included in the audit of the consumer" includes situations where the consumer's purchases were examined on an actual basis, or on a sample basis and the drop shipper's transaction was included in the population sampled. If an assessment was made based on the actual basis examination of the consumer's purchases, the liability due on the drop shipper's transaction would be eliminated. If an assessment was made based on errors found in a sample being projected over the audit period, the liability due on the drop shipper's transaction would be eliminated – even if the specific drop shipment purchase was not selected as a sample item. If no errors were noted, or if the errors were not projected over the audit period, the drop shipper's transaction would remain in the audit of the drop shipper.		
	Use Tax Transactions –	Use Tax Transactions - The auditor should also verify whether the consumer in California to whom the property was drop shipped holds a valid seller's permit, consumer use tax permit, Certificate of Registration – Use Tax, or use tax direct payment permit. If the consumer is registered with the Board, and the transaction is subject to use tax, the sale should be eliminated from the audit of the drop shipper.	Industry believes that once it is determined that the California consumer holds a permit, the sale should be eliminated from the audit of the drop shipper. Staff believes this treatment undermines the intent of section 6203 *Collection by the Retailer*. For consistency in audit procedures, the

Proposed New Regulation 1706, *Drop Shipments*, Establishing Drop Shippers Retail Selling Price; Proposed Audit Procedures for Drop Shipment Transactions

Comparison of Staff and Industry Proposals

Revised as of June 8, 2000

Action Item	Regulation and Audit Procedures Proposed by Staff	Regulation and Audit Procedures Proposed by Industry	Summary Comments
	<u>If the consumer is registered with the Board and an audit of the consumer is in progress, the transaction should be included as a liability of the consumer if the transaction is within the audit period of the consumer. If the Board is barred by statute from assessing tax against the consumer, the liability should remain in the audit of the drop shipper.</u> <u>When auditing a retailer in California it is standard procedure to examine the taxpayer's paid bills for any unreported purchases subject to use tax. During the examination of paid bills, if the auditor becomes aware that the consumer's purchase was the result of a drop shipment transaction, the auditor should verify if tax was already reported by the drop shipper before assessing the tax against the consumer. If the auditor determines that the transaction was already reported or assessed against the drop shipper, the transaction should not be included in the audit of the consumer.</u>		Board would have to consider expanding this procedure to all use tax transactions. In effect, any retailer who ships goods in use tax transactions would not have to collect use tax when they sell to customers who are permitized with the Board. Furthermore, ex-tax purchases from out-of-state vendors are consistently the largest single area of taxpayer noncompliance found in sales and ust tax audits. With only about three percent of active accounts being audited in any given year, the Audit Program could not be relied upon to ensure that all use tax is properly reported or assessed.

Proposed Regulation 1706. Drop Shipments.

Reference: Sections 6007, 6091, and 6203 Revenue and Taxation Code.

(a) **DEFINITIONS.** For purposes of this regulation:

(1) “Retailer engaged in business in this state” means and includes any person who would be so defined by Revenue and Taxation Code section 6203 if the person were a retailer.

(2) “True retailer” means and includes a retailer who is not a retailer engaged in business in this state and who makes a sale of tangible personal property to a consumer in California.

(3) “Drop shipment” means and includes a delivery of tangible personal property by an owner or former owner thereof, or factor or agent of that owner or former owner, to a California consumer pursuant to the instructions of a true retailer.

(4) “Drop shipper” means and includes an owner or former owner thereof, or factor or agent of that owner or former owner, who makes a drop shipment of tangible personal property.

(b) **GENERAL.** A drop shipment generally involves two separate sales. The true retailer contracts to sell tangible personal property to a consumer. The true retailer then contracts to purchase that property from a supplier and instructs that supplier to ship the property directly to the consumer. The supplier is a drop shipper. A drop shipper that is a retailer engaged in business in this state is reclassified as the retailer and is liable for tax as provided in this regulation. When more than two separate sales are involved, the person liable for the applicable tax as the drop shipper is the first person who is a retailer engaged in business in this state in the series of transactions beginning with the purchase by the true retailer.

(c) **APPLICATION OF TAX**

(1) Unless the sale to the California consumer and the use by the California consumer are exempt from sales and use tax as otherwise provided in the Sales and Use Tax Law, a drop shipper must report and pay tax measured by the retail selling price of the property paid by the California consumer to the true retailer.

(2) Except as provided in subdivision (d)(3) of this regulation, for reporting periods commencing on or after April 1, 2001, a drop shipper may calculate the retail selling price of its drop shipments of property based on its selling price of the property to the true retailer plus a mark-up of 10 percent (10%). A drop shipper may use a mark-up percentage lower than 10 percent if the drop shipper can document that the lower mark-up percentage accurately reflects the retail selling price charged by the true retailer to the California consumer.

If a mark-up percentage lower than 10 percent is developed in an audit of the drop shipper, the drop shipper may use that percentage for the subsequent reporting periods provided the drop shipper has not had a significant change in business operations. Provided there is no significant change in business operations, if a later audit develops a higher percentage, the Board would not assess additional tax based on that newly computed mark-up percentage. However, for subsequent reporting periods, the lower mark-up from the previous audit cannot be used, and the drop shipper must instead use the higher percentage developed in the most recent audit or 10 percent, whichever is lower.

(3) The procedures set forth in subdivision (d)(2) of this regulation do not apply to drop shipments of vehicles, vessels, and aircraft (also known as “courtesy deliveries”). For purposes of this regulation, “vehicle,” “vessel,” and “aircraft” are defined in Sections 6272, 6273, and 6274 of the Revenue and Taxation Code, respectively.

(d) **EXAMPLES.**

(1) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in this state. XYZ Inc. is the drop shipper liable for the applicable tax as the retailer.

(2) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is a retailer engaged in business in California. XYZ Inc. then contracts with Supplies Corp. to purchase the tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Whether or not Supplies Corp. is a retailer engaged in business in this state, XYZ Inc. is the drop shipper liable for the applicable tax as the retailer.

(3) ABC Co. is not a retailer engaged in business in this state. It contracts to sell tangible personal property to a California consumer. ABC Co. then contracts with XYZ Inc. to purchase the tangible personal property. ABC Co. instructs XYZ Inc. to ship the property directly to the California consumer. XYZ Inc. is not a retailer engaged in business in this state. XYZ Inc. then contracts with Supplies Corp. to purchase the tangible personal property, and instructs Supplies Corp. to ship the property directly to the California consumer. Supplies Corp. is a retailer engaged in business in this state. Supplies Corp. is the drop shipper liable for the applicable tax as the retailer.

(4) Dropshipper Company is a drop shipper of tangible personal property to California consumers on behalf of retailers who are not retailers engaged in business in this state. During its last audit, the Board developed and applied a mark-up of 8½ percent. During the current audit, the Board develops a mark-up of 11 percent. The Board will apply a mark-up of 8½

percent in the current audit provided there was no significant change in Dropshipper Company's business operations between the prior audit period and the current audit period. If there was a significant change in business operations, the Board will apply a mark-up percentage of 10 percent in the current audit. For periods after the current audit period, Dropshipper Company must use a 10 percent mark-up percentage.

(5) In the previous example, Dropshipper Company sold only computer hardware during the period covered by the prior audit, but in the period covered by the current audit, it also made considerable sales of computer software. Since there was a significant change in Dropshipper Company's business operations after the prior audit period, the mark-up of 8½ percent developed during that audit does not apply. The Board will apply a mark-up of 10 percent (because it is lower than the 11 percent mark-up developed during the audit).

(e) **BURDEN OF PROOF**

(1) An owner or former owner of tangible personal property, or a factor or agent of that owner or former owner, who, upon the instructions of that person's customer, delivers property to a California consumer is presumed to be a drop shipper liable for the applicable tax as the retailer. A person may overcome this presumption by accepting a timely resale certificate from that person's customer that includes a valid California seller's permit number. The acceptance of a resale certificate that does not include a valid California seller's permit number will not overcome the presumption.

(2) A person otherwise qualifying as a drop shipper under this regulation can overcome the presumption that the delivery is to a consumer by accepting a timely and valid resale certificate in good faith from the person in California to whom the property is delivered.

Steelcase

April 25, 2000

RECEIVED
APR 26 2000
PROGRAM PLANNING MANAGER

Ms. Freda Orendt-Evans
Program Planning Manager
Sales and Use Tax Department
State Board of Equalization
450 N. Street
Sacramento, CA. 95814

Dear Ms. Orendt-Evans:

This letter is in response to the *Revised Discussion for Issue Paper on Establishing the Drop Shipper's Retail Selling Price Under Section 6007* and the *Proposed Regulation 1706.*

It is still our opinion, for the reasons outlined in our letter dated January 13, 2000 (copy attached), that the tax base for a drop shipper should be the drop shipper's selling price. This is the price that is known to the drop shipper and that can be verified using the drop shipper's records. In addition to the facts included in the January 13 letter, I would like to add that in most cases in our industry, the true retailer is selling several manufacturers' products that are billed to the end user on the same invoice. This product mix adds to the difficulty in determining a mark-up for our products.

The Board Staff states that when section 6007 applies to a drop shipper, the drop shipper is reclassified to be the retailer and is responsible for payment of tax as if the drop shipper had contracted directly with the consumer for the retail sale of the property. The drop shipper is expected to collect the tax on a price that it not known to him from a customer that it does not have privity of contract.

If, however, the Board chooses not to use the drop shipper's selling price as the retail price, we agree that establishing a specific percentage would be a step in the right direction. The "safe harbor" percentage would provide an option that does not now exist.

We also agree that the two proposed alternative methods are acceptable, although the reference to a "significant change" in the drop shipper's business for the purposes of voiding the "prior audit" safe harbor is somewhat nebulous and will cause significant compliance problems unless clearly defined.

We do not agree with the requisite reporting of information on the California consumer to utilize safe harbor protections. This information is not always readily available in a format that is easily retrieved. It is also unclear as to the purpose of this information. This is similar to the requirement imposed by the state of Michigan, but in that state, the drop shipper is relieved from including the sale in its gross receipts subject to tax if the drop shipper reports the name and address of the person to whom the drop shipper delivered the product. The theory being that with this information, the state can collect the tax directly from the consumer.

Ms. Freda Orendt-Evans
April 25, 2000
Page 2

We agree with the Staff that establishing separate mark-up percentages is not desirable. In our opinion, separate percentages will complicate rather than simplify the situation.

We agree with the Board that audit procedures for audits of drop shippers should be implemented. We agree that drop shipments should be allowed as a sale for resale if the true retailer is registered for California sales or use tax, or is not registered but has been determined to be engaged in business in California.

We do not agree with the proposed audit procedures for use tax transactions. We feel that once it has been determined that the consumer is registered with the state of California, the sale should be eliminated from the audit of the drop shipper. It is not necessary for the auditor to determine that the tax has been self-assessed by the consumer or picked up in an audit of the consumer. Keep in mind that the consumer is not purchasing from the drop shipper. The consumer is purchasing from the true retailer. In order to determine that the tax has been paid, the auditor will have to get the invoice information from the true retailer. The drop shipper invoice data will be of minimal value in determining whether tax has been paid. The results will be similar to our experience with sending XYZ letters to the consumers.

Section (a)(3)(b) of the proposed regulation seems to be limited to a specific transaction. If a retailer is "engaged in business", it is engaged in business for all transactions. We recommend clarification, or in the alternative, striking the words "for the purposes of the transaction".

Thank you for the opportunity to provide our comments. Please contact us with any questions.

Sincerely,

Michael F. Lewakowski

Michael F. Lewakowski
Manager, State and Local Taxes
CH-2E-02

Fax 616-246-9623 Voice 616-247-3410

Enclosure (1/13/00 letter)

Steelcase Inc.
The Office Environment Company
Tax Services

P.O. Box 1967
Grand Rapids, MI 49501-1967

January 13, 2000

Ms. Freda Orendt-Evans
Program Planning Manager
Sales and Use Tax Department
State Board of Equalization
450 N. Street (MIC:92)
Sacramento, CA 95814

Dear Ms. Orendt-Evans:

Thank you for the opportunity to present our initial views on the regulation project regarding a "safe harbor" mark-up on drop-shipment sales.

As a manufacturer, it is extremely difficult to obtain reliable information as to the actual mark-up charged by the unrelated sellers of our products. Our industry is very competitive and significant and varied discounting occurs in order to win business.

In a "drop-ship" context, it is even more difficult for us to estimate the retailer's mark-up if we try to collect tax from the end user measured by the end user's purchase price. Whatever mark-up percentage is chosen, it is sure to be "wrong" - either too high or too low. If the mark-up is too high, the customer will tell us about it, and we will be forced to issue a billing adjustment. This creates administrative burdens on us. If the mark-up is too low, we will never hear about it and the State will not collect the correct amount of tax.

Therefore, we feel that the easiest proposal for us to administer would be one whereby we would bill and collect the tax based upon our cost - this is the only amount known to us and is a 100% correct number from our records.

We wish to point out that there is a further administrative problem even if we were to collect tax based upon our selling price. Many of our shipments are to installing dealers located in a jurisdiction where the tax rate is "X"%. However, in many cases our products are actually installed in another jurisdiction where the tax rate is "Y"%. Hopefully, the proposed regulation will provide an administrative safeguard to protect us from collecting at the wrong rate.

As an additional comment, the products in our industry require significant on-site installation services. We wish to draw your attention to the Board's 1999 regulation, which deems 10% of the total charges to be non-taxable installation labor. This new regulation works very well for us and should be incorporated into any future deemed mark-up regulation.

Thank you for the opportunity to provide our initial comments. We look forward to providing additional comments as this regulation process continues.

Very truly yours,

/s/ Fred W. Brenner, Jr.

Fred W. Brenner, Jr.
Vice-President, Taxes/
Assistant Treasurer

Drop Shipment Information
District Survey

	TYPE OF PRODUCT SOLD	MARK-UP ON DROP SHIPPER'S SELLING PRICE (1)	NOTES
1	Forklifts	10%	The commissions earned by drop shipper were converted to retail selling price.
2	Computer accessories	53%	Drop shipper's overall FITR mark-up was used.
3	Luggage	110%	Used suggested retail selling prices from drop shipper's price list and out-of-state vendor.
4	Industrial batteries and chargers	15%	
5	Tote bags	21%	Actual sales invoice copies obtained from selected California buyers.
6	Go-cart and mini bike components	20%	Estimated mark-up % per discussion with taxpayer.
7	Furniture accessories	105%	Retail prices obtained from out-of-state customer's mail order catalogs.
8	Modular piping	20%	Estimated mark-up.
9	Software/computer equipment		Mark-up not available.
10	Bicycles	30%	Estimated mark-up.
11	Computer parts & notebook computers	20%	Estimated mark-up.
12	Lamps	25%	Prior audit's mark-up was used. This was discussed with the accounting manager.
13	Photo exposure boards, projectors, lamps, lenses	18%	21%, 12%, 30% and 10% mark-ups per four ultimate customers (CA customers) - average 18%.
14	Corrugated boxes	20%	1 transaction for $190 - 20% mark-up was used; the rest comprised of 3 different out-of-state customers who did not mark-up to their CA customers (at cost). These transactions were related to sales of printing and cutting dies.
15	Drafting machines and pressure regulators	10%	
16	Components of commercial weight scales	50%	Estimated mark-up.
17	Plastic bags Can liners	10% 5%	
18	Nuts & bolts		Mark-up not available.
19	Forklifts/parts	20%	
20	Electronic consumer products		Mark-up not available.
21	Restaurant supplies	17%	
22	Computer equipment	11%	
23	Wine cabinets	33%	
24	Wine cabinets	33%	
25	Forklifts	16%	Average mark-up.
26	Cooling tower	28%	
27	Custom mfged safes	15%	Mark up was estimated at 15%.
28	Manufactured physical fitness/therapy equipment		Mark-up not available.
29	Mattress pads	30%	Taxpayer received information from the out of state retailer regarding the "average" mark-up on the selling price.

(1) These are the markups found in single audits and do not necessarily reflect industry averages.

Drop Shipment Information
District Survey

	TYPE OF PRODUCT SOLD	MARK-UP ON DROP SHIPPER'S SELLING PRICE (1)	NOTES
30	Vending machines		Mark-up not available.
31	Power protection devices	20%	Mark-up based on phone conversation with buyers.
32	Asphalt equipment		Mark-up not available.
33	Computer equipment	10%	Mark-up estimated based on experiences with other businesses in this industry.
34	Window coverings	11%	
35	Computer peripherals		Mark-up not available.
36	Canned software	30%	
37	CD Duplication equip & software	30%	
38	Murals painted on canvas & fabric	110%	
39	Computer software; relational databases for business and government use	10%	
40	Software	15%	
41	Software	15%	Estimated amounts.
42	Memory chips	10%	
43	Mfg. equipment	20%	
44	Drive shafts & rollers	20%	
45	Scanning equipment	10%	
46	Sign making machines	20%	
47	Computer servers	2%	
48	Ergonomic accessories	171%	
49	Video games	11%	
50	Wine cellars and cigar humidores		Selling price to CA consumer was estimated based on the tax remitted by the consumer to drop shipper. Tax divided by 7.25%.
51	Computers and related products	29%	
52	Classroom equipment	2%	
53	Auto emergency kits	10%	
54	Computer hard drives	10%	
55	Bar code printers	20%	
56	Marketing products - pencils, mugs, etc.		Mark-up not available.
57	Quality control equipment		Mark-up not available.
58	Fruit & vegetable sorting/grading equip		Mark-up not available.
59	Printing		Mark-up not available.
60	Farm equipment	20%	
61	Plastic pipe used by electical & agricultural contractors	11%	Average mark-up; audited mark-up ranged from 4% to 18%.
62	Infrared drying systems	33%	Mark-up based on support received from other customers in which drop shipments were made.
63	Screen print tee shirts and embroidery	25%	

(1) These are the markups found in single audits and do not necessarily reflect industry averages.

Drop Shipment Information
District Survey

	TYPE OF PRODUCT SOLD	MARK-UP ON DROP SHIPPER'S SELLING PRICE (1)	NOTES
64	Computer hardware & software	17%	Mark-up based on comparing retail selling price to that charged to the middle person.
65	Computer hardware & software	17%	Mark-up based on comparing retail selling price to that charged to the middle person.
66	Lumber sold for utility poles	4%	Mark-up based on retail selling price.
67	Consumer electrics such as televisions, radios and telephones	11%	Estimated from provided measure multiplied by 7.25%.
68	Industrial blowers		Mark-up not available.
69	Office furniture	33%	
70	Hand trucks	10%	
71	Office furniture and partitions	33%	
72	Metal cabinets and lockers	59%	
73	Private label cleaners and decorative floor coverings	150%	
74	Footwear	3%	
75	Ice machines and reach in freezers	10%	
76	Consumer electronics		Mark-up not available.
77	Office products	23%	
78	Fabricated metal products (lockers, racks)	10%	
79	Carpets and rugs	20%	Exempt sales.
80	Computers & related equip	15%	
81	Computer hardware & software	15%	Mark-up estimated.
82	Business forms	15%	Mark-up estimated.
83	Security Cameras	17%	
84	Forklifts	10%	Estimated.
85	Micrographic eqt./suppl.	25%	
86	Walk off floor matting	10%	
87	Panel sizing mach/parts		Mark-up not available.
88	Counters - food prep.		Mark-up not available.
89	Computer networking equip	30%	Estimate.
90	Industrial metal cabinets	100%	Estimated markup.
91	Carpet & flooring mat'ls	10%	Estimated markup.
92	Hair dryers & mirrors	10%	Estimated markup.
93	Auto tire changers & comp.	15%	Estimated markup
94	Printed products	15%	Estimated markup.
95	Various merchandise	25%	Estimated markup.

(1) These are the markups found in single audits and do not necessarily reflect industry averages.